

***City of Seattle –
City Light Department***

*Financial Statements for the
Years Ended December 31, 2004 and 2003,
Required Supplementary Information and
Independent Auditors' Report*

CITY OF SEATTLE – CITY LIGHT DEPARTMENT

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INDEPENDENT AUDITORS' REPORT

Superintendent
City of Seattle – City Light Department
Seattle, Washington

We have audited the accompanying balance sheets of the City of Seattle – City Light Department (the “Department”) as of December 31, 2004 and 2003, and the related statements of revenues, expenses, and changes in equity and of cash flows for the years then ended. These financial statements are the responsibility of the Department’s management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department as of December 31, 2004 and 2003, and the changes of its equity and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management’s discussion and analysis on pages 2 through 10 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Department’s management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Deloitte & Touche LLP

April 22, 2005

CITY OF SEATTLE – CITY LIGHT DEPARTMENT

MANAGEMENT’S DISCUSSION AND ANALYSIS DECEMBER 31, 2004

The following discussion and analysis of the financial performance of the City of Seattle – City Light Department (the “Department”) provides a summary of the financial activities for the year ended December 31, 2004. This discussion and analysis should be read in combination with the Department’s financial statements, which immediately follow this section.

RESULTS OF OPERATIONS

Condensed Revenues and Expenses—Year ended December 31:

	2004	2003
Operating revenues	\$ 777,918,589	\$ 739,005,298
Nonoperating revenues	<u>4,286,396</u>	<u>3,849,386</u>
Total revenues	782,204,985	742,854,684
Operating expenses	710,002,913	700,067,504
Nonoperating expenses	<u>76,304,899</u>	<u>77,054,688</u>
Total expenses	786,307,812	777,122,192
Capital contributions	10,580,789	22,089,096
Grants	<u>7,282,976</u>	<u>4,044,558</u>
Net income (loss)	<u>\$ 13,760,938</u>	<u>\$ (8,133,854)</u>

SUMMARY

The Department realized net income of \$13.8 million in 2004, an improvement of \$21.9 million from the net loss of \$8.1 million recorded in 2003. Higher revenue from sales of energy to retail customers accounts for most of the improvement in financial results. Retail revenues were \$24.5 million higher in 2004 than in the prior year. Revenue from wholesale power sales (net of the cost of wholesale purchases) was \$113.6 million, or virtually the same amount as in 2003. Lower power costs, in particular a reduction of \$26.1 million in the cost of power purchased from the Bonneville Power Administration, were partially offset by a slight increase in other operations and maintenance costs. Income from fees and grants were \$8.3 million lower than in 2003.

In December 2004, the Department amortized the final monthly installment of \$8.3 million in excess power costs deferred from 2001. In 2002, 2003, and 2004, \$300 million in deferred power costs was amortized in equal monthly amounts. If power costs had not been deferred from 2001 and amortized over the 2002-04 period, net income in 2004 would have been \$113.8 million.

REVENUES

Retail Revenue—Revenue from sales of energy to retail customers increased from \$552.2 million in 2003 to \$576.7 million in 2004, an increase of 4.4%. Virtually all of this increase occurred in the non-residential rate classes. Revenue billed to residential customers totaled \$199.2 million, an increase of only \$0.1 million from the prior year. Billings to non-residential customers generated \$376.9 million in revenue, an increase of \$24.8 million from the 2003 level. Recognition of unbilled revenue added \$1.1 million to revenue in 2003, but only \$0.6 million in 2004.

Most of the increase in non-residential revenue from 2003 to 2004 can be attributed to a number of special nonrecurring circumstances.

- ◆ **Streetlight Payments**—The rate ordinance which took effect on December 24, 1999 allocated the costs of streetlighting in Seattle and Tukwila to the general customer base in those jurisdictions and set rates to recover streetlighting costs from those customers. Previously, such costs had been paid by the general funds of the cities of Seattle and Tukwila. On November 13, 2003, the Washington State Supreme Court ruled that this practice constituted an illegal tax. Effective with the date of the Supreme Court decision, the Department resumed billing the cities of Seattle and Tukwila for streetlight costs, generating \$0.5 million in revenue in 2003 and \$6.0 million in 2004.
- ◆ **Revenues from Interruptible Customer**—In calendar years 2002 and 2003, the Department had served one customer in the High Demand General Service rate class on the basis of a contract which set a rate for that customer that was discounted by approximately 20% from the rates paid by other customers in that rate class. The contract required the customer to compensate the Department for the lower rates charged in 2002 and 2003 by paying a higher rate beginning January 1, 2004 until consumption reached a level equal to five times actual consumption in calendar year 2000. In addition, the contract gave the Department the right to interrupt the customer under certain circumstances. In March 2004, the Department and the customer agreed to an amendment to the contract, which provided that the customer would make a one-time payment of \$9 million to compensate the Department for the discounted rates paid in 2002 and 2003. The amended contract also allowed the customer to continue to pay a discounted rate in 2004, but at a higher level than in 2002 and 2003. The \$9.0 million payment was recorded as revenue in 2004.
- ◆ **Recovery of Underbillings**—Revenue of \$1.0 million was recorded in 2004 to recover amounts underbilled to certain non-residential customers.

Of the total increase of \$24.8 million in non-residential billings, \$15.4 million can be attributed to these three developments. Billings to the single interruptible customer account for \$2.0 million of the remaining increase of \$9.3 million in non-residential revenue. Amounts billed to other non-residential customers increased by \$7.3 million from 2003 to 2004, reflecting an increase of 1.3% in the average billing rate and growth of 0.9% in energy consumption, as the local economy continued its recovery from the recent recession.

Wholesale Revenue—Sales of surplus power in the wholesale market generated \$163.3 million in 2004, an increase of \$25.6 million from the prior year. However, purchases of wholesale energy were \$25.5 million higher in 2004, increasing from \$24.2 million to \$49.7 million. Therefore, wholesale market transactions, including both sales and purchases, produced net revenue of \$113.6 million in 2004, a slight increase of \$0.1 million over the 2003 level. In both years, the net amount of surplus energy available for sale in the wholesale market was below normal levels, due to low levels of precipitation in the watersheds affecting hydroelectric generation. In 2004, net surplus energy of 2,970,420 MWh was available to the Department, slightly below the net surplus of 3,054,469 MWh in 2003. Under normal water conditions, approximately 4,600,000 MWh of surplus energy would have been anticipated. The shortfall in surplus energy was partially offset by

wholesale market prices that were higher than anticipated. In 2004 the Department's wholesale sales were accomplished at an average price of \$39.59 per MWh. The price of wholesale purchases averaged \$41.29 per MWh. The comparable figures in 2003 were \$37.27 per MWh for sales and \$37.61 per MWh for purchases.

Other Power-Related Revenue—This category of revenue consists of a number of miscellaneous power-related transactions which are considered separately from short-term sales and purchases of surplus power in the wholesale market. Revenue in this category fell from \$34.1 million in 2003 to \$20.0 million in 2004. The major cause of this decrease was a reduction in the revenue related to transmission basis sales.

Revenues in 2004 were also lower than in 2003 for other types of transactions.

- ◆ Sales of transmission capacity to other utilities generated \$2.8 million in revenue in 2003, but only \$0.9 million in 2004.
- ◆ Energy delivered to Tacoma Power under a seasonal exchange agreement was valued at \$1.1 million in 2003. The termination of this agreement in October 2003 meant that no revenue from this source was recorded in 2004.
- ◆ Under the terms of its agreement with Pacific Power Marketing for the delivery of power from the State Line Wind project, the Department realized \$1.8 million in revenue for the provision of integration and exchange services in 2003. No integration and exchange services were provided by the Department in 2004.

Offsetting these decreases in revenue from power-related transactions were a number of areas in which revenues increased.

- ◆ Since October 2003, the Department has sold spinning reserves to other utilities purchasing the Slice product from the Bonneville Power Administration ("BPA"). For the 12 months of 2004, these sales generated \$6.2 million in revenue, compared with \$1.6 million in the final three months of 2003.
- ◆ The Department received \$39.3 million through 2004 from BPA for the purchase of energy savings. An additional \$12.2 million from BPA will be received through 2006. Proceeds are being recognized as revenue in equal monthly amounts through September 30, 2011, the termination date of the power sales agreement with BPA. Revenue recognized in 2004 totaled \$5.8 million, an increase of \$2.3 million over the 2003 level.

Other Revenues—Revenues from a variety of other sources increased from \$15.0 million in 2003 to \$17.9 million in 2004, an increase of 19.3%. There were increases and decreases in a number of the components of this category that tended to offset one another.

- ◆ In 2003 non-utility operations included revenue of \$1.2 million from settlement of a claim related to the performance of turbine runners installed at the Boundary plant. In 2004 the value of the Department's art collection was written off in the amount of \$0.7 million. The effect of these two developments was to lower revenue from non-utility operations by \$1.9 million relative to the 2003 level.
- ◆ Revenue from the rental of transmission towers to telecommunications companies for the installation of cell phone antennas declined from \$0.9 million in 2003 to \$0.6 million in 2004.

- ◆ Revenue billed to customers to reimburse the Department for operations and maintenance expenses, including work performed for the Seattle Monorail Authority and for telecommunications companies, increased from \$3.3 million in 2003 to \$4.6 million in 2004.
- ◆ ***Streetlight Refunds***—As a result of the Supreme Court decision, the City of Seattle was required to reimburse the Department for \$23.9 million in streetlight costs that would have been billed to the City for streetlight costs from December 24, 1999 to November 13, 2003. The Department was required to refund to its customers in the city of Seattle the amount collected for streetlight costs over that period and to refund to its customers in the city of Tukwila the amount collected from December 24, 1999 through April 30, 2003. This amount was estimated to be \$21.5 million. The Department recorded the \$2.4 million difference between the \$23.9 million in payments from the City of Seattle and the \$21.5 million in customer refunds as other operating revenues in 2004.
- ◆ In 2004, the Department realized revenues totaling \$1.0 million for past payments to the City to be refunded.

EXPENSES

Power Expenses—Expenses related to the production and purchase of power increased from \$440.6 million in 2003 to \$442.8 million in 2004, an increase of 0.5%. However, included in these figures are the increase of \$25.5 million in short-term wholesale power purchases that was discussed above in connection with short-term wholesale power sales and the decrease of \$13.3 million related to transmission basis sales. If these two elements are excluded, power costs declined from \$403.0 million in 2003 to \$393.0 million in 2004.

Generation—Costs of operating and maintaining the Department’s hydroelectric plants increased slightly from \$20.2 million in 2003 to \$20.3 million in 2004. A decrease of \$0.8 million in regulatory charges by the Federal Energy Regulatory Commission (“FERC”) was offset by a higher valuation of energy delivered to Pend Oreille County Public Utility District (“PUD”) to compensate the PUD for the encroachment of the Department’s Boundary plant on the PUD’s Box Canyon plant and by increases in maintenance costs at the Boundary and Skagit Projects.

Purchased Power—The cost of power purchases under long-term contracts with other utilities declined from \$240.5 million in 2003 to \$229.4 million in 2004. Power purchased from BPA decreased in cost from \$157.1 million in 2003 to \$131.0 million in 2004, a reduction of \$26.1 million. Over 70% of the power purchased from BPA by the Department is in the form of a “Slice-of-the-System,” through which the Department purchases 4.6676% of the output of the Federal Columbia River Power System and pays the same percentage of the System’s actual costs. Monthly payments are based on a projection of the costs of the System, with provision for an annual true-up when actual costs have been determined. In 2003 the Department recorded expenses of \$8.6 million in true-up payments for Slice costs in the contract year ending September 30, 2002. In 2004 the Department true-up calculations resulted in net credits totaling \$4.4 million. The Slice true-up therefore accounts for \$13.0 million of the \$26.1 million variance in BPA costs. The remainder of the variance is attributable to a reduction in the average rate charged by Bonneville and a reduction in the amount of energy delivered to the Department pursuant to a provision in the Department’s contract with BPA which reduces the Department’s entitlement to purchase energy by the amount of conservation savings purchased by BPA.

The cost of other long-term purchased power contracts increased from \$83.4 million in 2003 to \$98.4 million in 2004. The following contracts showed increases over the prior year:

- ◆ **Lucky Peak**—The 2002 refinancing of Lucky Peak bonds restructured debt service payments for the project. Debt service in 2003 consisted only of interest on the bonds; principle payments began in 2004 and added \$5.1 million to the cost of power. Total Lucky Peak costs increased from \$12.2 million in 2003 to \$16.8 million in 2004.
- ◆ **State Line Wind Project**—Capacity purchased by the Department from the State Line Wind Project increased from 100 MW in 2003 to 150 MW effective January 1, 2004 and 175 MW effective July 1, 2004. Expenses associated with this purchase increased from \$12.9 million in 2003 to \$18.3 million in 2004, reflecting a 61.2% increase in the amount of energy delivered.
- ◆ **Klamath Falls Cogeneration Facility**—Deliveries of energy from the Klamath Falls cogeneration facility were 9.8% higher in 2004 than in 2003. Natural gas prices were also significantly higher. As a result, the cost of power from Klamath Falls increased from \$36.3 million in 2003 to \$42.0 million in 2004.
- ◆ **Grand Coulee Project Hydroelectric Authority (“GCPHA”)**—An increase in contractual incentive payments under the Department’s contract with GCPHA resulted in an increase in costs under this contract from \$4.8 million in 2003 to \$5.7 million in 2004. Under the terms of the contract, the incentive payment to the Authority is linked to the Department’s cost of power from other sources, which was higher in 2004 than in 2003.
- ◆ Other contracts for the purchase and exchange of power were recorded in other purchased power contracts, the net effect of which was a decrease of \$1.5 million in 2004 power costs relative to 2003.

Amortization of deferred power costs totaled \$100 million in both 2004 and 2003. As of December 31, 2004, deferred power costs were fully amortized.

Transmission—The cost of operating and maintaining transmission to the Department’s lines increased from \$4.4 million in 2003 to \$5.3 million in 2004 due to increased maintenance activity on overhead lines. The cost of wheeling power over the facilities of other utilities increased from \$30.1 million in 2003 to \$30.9 million in 2004. Additional transmission capacity to transmit power from the State Line Wind Project added \$0.5 million to wheeling costs in the fourth quarter of 2004. The remainder of the increase is attributable to a 1.5% increase in BPA wheeling rates effective October 1, 2003.

Other Power Costs—System control costs totaled \$5.7 million in 2004, a reduction of \$0.3 million from the prior year. Load factoring costs of \$0.4 million in 2003 were not repeated in 2004.

Other Operations and Maintenance Expense—Operations and maintenance expenses in the functional areas of distribution, customer service, energy management, and administration and general activities increased from \$128.6 million in 2003 to \$131.9 million in 2004, an increase of 2.6%. Significant year-to-year changes include the following:

- ◆ **Distribution**—Expenses for the operation and maintenance of distribution facilities increased from \$39.1 million in 2003 to \$41.0 million in 2004. Growth in the apprenticeship program and a higher level of tree-trimming activity account for most of the increase.
- ◆ **Customer Services**—Customer services expenses of \$33.7 million in 2004 represented an increase of \$2.6 million from the 2003 level. Growth in bad debt expense accounts for the majority of this increase. Bad debt expense on retail accounts grew from \$7.4 million in 2003 to \$10.3 million in 2004, an increase of \$2.9 million. Offsetting this increase was a reduction of \$1.1 million in uncollectible power accounts. In 2003 the bankruptcy of two of the Department's counterparties led to the recognition of \$1.1 million in uncollectible power accounts; there were no such events in 2004. Increases in meter-reading and billing costs account for the remainder of the growth in customer service costs.
- ◆ **Energy Management**—Energy management expenses experienced moderate growth of \$0.2 million, from \$11.0 million in 2003 to \$11.2 million in 2004. Growth in the amortization of past conservation investments was the source of the increase.
- ◆ **Administration and General**—Expenses in this category, net of administrative and general expenses allocated to capital, conservation and other deferred projects, declined from \$47.4 million in 2003 to \$46.0 million in 2004. Reductions in legal expenses, claims for injuries and damages, and rental expenses account for the bulk of the decrease in administrative and general expenses.

Taxes—Payments of city and state taxes and contractual payments to local jurisdictions showed a net decrease of \$0.2 million, from \$61.6 million in 2003 to \$61.4 million in 2004, in spite of the increase in retail revenue. Since city and state taxes are assessed on gross retail revenues, an increase in tax payments would have been expected. However, payments from the City of Seattle for streetlights, which resumed in November 2003, were not taxable; through November 2003 streetlight costs were recovered through the rates of all customer classes in Seattle and Tukwila and were taxable. The change in the taxability of streetlight revenues reduced tax payments by \$0.5 million from 2003 to 2004. In 2003 the Department was assessed \$1.1 million by the state on the basis of the state's audit of past tax payments. In 2004 the Department successfully challenged some of the audit findings and recovered \$0.3 million of the amounts assessed in 2003. Contractual payments to suburban jurisdictions under the terms of the Department's franchises increased by \$0.3 million from 2003 to 2004 due to the signing of a new franchise with the city of Tukwila, which took effect in March 2003.

Depreciation—Depreciation expense totaled \$73.9 million in 2004, an increase of \$4.6 million from the level of the prior year. Depreciation of distribution and general plant each increased by about \$2.0 million, reflecting the Department's investment in capital improvements in those areas. An increase of \$0.5 million was recorded in the depreciation of hydraulic plant.

OTHER NONOPERATING INCOME AND EXPENSE

Interest expense in 2004 decreased by \$0.1 million from the level of \$73.9 million recorded in 2003. The increase in interest expense on first-lien bonds showed a net increase of \$1.9 million, from \$71.3 million in 2003 to \$73.2 million in 2004. The increase in interest expense reflects the increase in outstanding bonds resulting from bond issues in July 2003 and December 2004, offset by savings from the refunding components of those issues. Interest on second-lien variable-rate bonds increased from \$1.0 million in 2003 to \$1.1 million in 2004 as interest rates rose in the latter year. Interest expense in 2003 of \$4.8 million on revenue anticipation notes outstanding in that year was not repeated in 2004 due to the redemption of those notes in March and November 2003. Interest expense of \$2.6 million was recorded in 2004 to compensate customers in Seattle and Tukwila for the loss of use of funds that they had paid through their rates for streetlight costs from 2000 through 2003. Compensation of customers for loss of use was required by court decisions in litigation contesting the legality of the Department's method recovering streetlight costs. The allowance for funds used during construction, which is an offset to interest expense, decreased from \$4.3 million in 2003 to \$3.5 million in 2004.

Amortization expenses related to bond issue costs, bond premium and discount and refunding loss declined from \$3.1 million in 2003 to \$2.5 million in 2004 as a result of the issuance of refunding and new-money bonds in 2003 and 2004.

Investment Income—Investment income totaled \$2.5 million in 2004, a reduction of \$1.3 million from the 2003 level. In 2003 funds available for investment were at higher levels as the Department accumulated substantial cash balances for the repayment of revenue anticipation notes that matured in that year. With cash balances at more normal levels in 2004, interest income decreased.

Gain on Sale of Property—The Department realized gains amounting to \$2.2 million on the sale of properties in 2004, an increase of \$1.5 million from the gains recorded in 2003.

Fees and Grants—Fees and grants declined by \$8.3 million in 2004 from the unusually high level of \$26.1 million in 2003, due mainly to the occurrence of one-time events in 2003 that were not repeated in 2004. The Department recorded \$9.2 million in in-kind contributions in 2003 related to arterial improvements carried out by the Seattle Engineering Department. The Department also received \$3.8 million from BPA in reimbursement for 2003 costs incurred in reinforcing transmission lines to stabilize the regional transmission grid. Neither of these events was repeated in 2004. Offsetting these declines was an increase of \$2.9 million in installation charges. Grants increased by \$3.2 million primarily as a result of work performed for Sound Transit in connection with the construction of the regional light rail system.

CONDENSED BALANCE SHEETS

	December 31, 2004	December 31, 2003
Assets:		
Utility plant	\$1,408,183,614	\$1,390,857,362
Capitalized purchased power commitment	35,662,876	45,130,152
Restricted assets	123,718,739	159,432,145
Current assets	252,414,183	178,234,062
Other assets	<u>206,203,653</u>	<u>286,898,970</u>
Total assets	<u>\$2,026,183,065</u>	<u>\$2,060,552,691</u>
Liabilities:		
Long-term debt	\$1,459,292,622	\$1,462,609,162
Noncurrent liabilities	45,010,305	55,717,497
Current liabilities	185,063,263	215,129,588
Deferred credits	<u>32,929,702</u>	<u>36,970,209</u>
Total liabilities	1,722,295,892	1,770,426,456
Equity:		
Invested in capital assets—net of related debt	128,453,544	158,451,970
Restricted:		
Deferred power costs		100,000,000
Other	72,156,591	56,831,686
Unrestricted	<u>103,277,038</u>	<u>(25,157,421)</u>
Total equity	<u>303,887,173</u>	<u>290,126,235</u>
Total liabilities and equity	<u>\$2,026,183,065</u>	<u>\$2,060,552,691</u>

UTILITY PLANT

Utility Plant Assets increased \$96.8 million for 2004.

The hydroelectric system increased by \$19.8 million as follows: \$4.3 million for the completed portion of the North Cascade Environmental Learning Center; \$0.5 million to upgrade exhibits at Newhalem; \$12.8 million for the Boundary rehabilitation project in progress; and \$0.7 million for Gorge Road improvements. Other hydraulic system increased \$1.5 million.

Transmission plant increased by \$0.9 mainly due to replacement of circuit breakers at substation switch yards.

Distribution plant increased by \$60.6 million as follows: \$7.8 million for poles and \$6.2 million for overhead conductors for capacity additions and relocations; \$4.5 million for underground conduit; \$7.7 million for network underground conduit; \$7.3 million for underground conductors; \$8.5 million for network underground conductors for meters, Broad Street substation network, and Sound Transit; and \$5.7 million for transformers. An increase of \$12.9 million was due to overhead services, underground services, network underground, meter additions, and streetlights.

General Plant assets increased by \$15.6 million as follows: \$6.9 million for communication equipment for the Boundary Project; \$2.5 million for systems software for the Department's data warehouse; \$5.2 million by the Department for computer equipment, network and other software; and \$1 million for other general plant assets.

Land and land rights increased \$0.9 million. Land was purchased for wildlife protection in the Skagit watershed for \$0.8 million. Two substation properties were sold for \$1.7 million, and the Department's interest in Skookumchuck was sold for \$0.6 million, resulting in a gain of \$0.4 million.

Nonoperating property net of accumulated depreciation increased \$1.3 million. Art inventory was written off by \$0.7 million.

OTHER ASSETS

Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation*, provides for the deferral of certain utility costs and related recognition in future years as the costs are recovered through future rates. Deferred costs are authorized by resolutions passed by the Seattle City Council and include capitalized energy management services, deferred power costs, capitalized relicensing costs, deferral of payments to the Province of British Columbia under the High Ross agreement, and other deferred charges and assets. Detail for other deferred charges and assets—net, is provided in Note 10 to the accompanying financial statements.

Deferred assets totaled \$206.2 million at December 31, 2004, decreasing \$80.7 million from December 31, 2003. In 2001, \$300 million of short-term wholesale power costs were deferred for recovery through future revenues and were fully amortized by December 31, 2004 at a rate of \$100 million per year.

The Department is subject to true-up payments for the Department's fixed 4.6676 percentage of actual output and costs of Bonneville Slice power through September 30, 2011. In 2002, \$10.4 million was deferred for the Bonneville Slice contract true-up billing and \$1.9 million remained unamortized at December 31, 2003. A true-up credit for federal fiscal year 2003 in the amount of \$6.3 million was deferred as of December 31, 2003, and was recognized during 2004. Bonneville rate adjustments will be passed through to retail electric customers in the form of rate adjustments in accordance with Section 25.49.081 of the Seattle Municipal Code.

LONG-TERM DEBT

Activity during 2004 for long-term debt included issuance of \$284.9 million in Municipal Light & Power Improvement and Refunding Revenue Bonds in December. The proceeds were used to fund the ongoing Capital Improvement Program and to defease certain prior lien bonds. Scheduled redemption of certain prior lien bonds also took place in the normal course of business. A note payable to the City of Seattle for \$5.6 million for purchase of real estate was issued in 2003 and is due in 2005 (see Note 6 of the accompanying financial statements).

After payment of cash operating expenses, net revenues available to pay debt service were equal to 2.39 times principal and interest on first lien bonds. If the amortization of \$100 million in power costs deferred from 2001 is factored into the calculation, net revenues would be equal to 1.58 times first lien debt service.

ENVIRONMENTAL LIABILITIES

Environmental liabilities totaled \$5.8 million at December 31, 2004 and 2003. The liabilities are primarily attributable to the estimated cost of remediating contaminated sediments in the lower Duwamish Waterway, which was designated a federal Superfund site by the Environmental Protection Agency in 2001. The Department is considered a potentially responsible party for contamination in the Duwamish River due to land ownership or use of property located along the river.

RISK MANAGEMENT

The Department's exposure to market risk is actively managed by a Risk Management Committee. The Department engages in market transactions only to meet its load obligations or to sell surplus energy. Except for strictly limited and closely monitored intraday and interday trading to take advantage of owned hydro storage, the Department does not take market positions in anticipation of generating revenue.

With a significant portion of the Department's revenue expected from wholesale market sales, great emphasis is placed on the management of market risk. Processes, policies, and procedures designed to monitor and control these market risks, including credit risk, are in place and engagement in the market is strictly governed by those policies. A consulting firm is in the process of reviewing the Department's power marketing function and is expected to make its report in 2005.

The Department measures the market price risk in its portfolio on a weekly basis using a modified revenue at risk measure that reflects not only price risk, but also the volumetric risk associated with its hydro-dominated power portfolio. Monte Carlo simulation is used to capture financial risk, and scenario analysis is used for stress testing.

The Department takes a very conservative approach to managing volumetric risk, assuming hydro generation at the 95% exceedance level until observed precipitation or snow pack surveys indicate otherwise.

While the Department's portfolio includes purchased power from a gas turbine (a share of the Klamath Falls cogeneration facility), the Department's exposure to gas price excursions is limited, as the Department has monthly dispatch rights for that resource and only exercises those rights if the economics of operating the plant is favorable.

The Department mitigates credit risk by trading only with qualified counterparties. The Credit Committee, a subcommittee of the Risk Management Committee, establishes credit policies and counterparty limits based on approved criteria. The Credit Committee monitors credit exposure and updates counterparty limits to reflect their most current financial condition and creditworthiness.

CITY OF SEATTLE – CITY LIGHT DEPARTMENT

BALANCE SHEETS

DECEMBER 31, 2004 AND 2003

ASSETS	2004	2003
UTILITY PLANT—At original cost:		
Plant in service—excluding land	\$ 2,249,506,046	\$ 2,152,680,745
Less accumulated depreciation	(980,740,177)	(914,978,513)
	1,268,765,869	1,237,702,232
Construction work-in-progress	85,659,390	101,523,497
Nonoperating property—net of accumulated depreciation	13,112,083	11,860,650
Land and land rights	40,646,272	39,770,983
	1,408,183,614	1,390,857,362
CAPITALIZED PURCHASED POWER COMMITMENT	35,662,876	45,130,152
RESTRICTED ASSETS:		
Municipal Light & Power Bond Reserve Account:		
Cash and equity in pooled investments	84,682,384	79,622,670
Bond proceeds and other:		
Cash and equity in pooled investments	5,219,032	7,406,387
Investments	26,888,326	68,244,446
Special deposits and other	6,928,997	4,158,642
	123,718,739	159,432,145
CURRENT ASSETS:		
Cash and equity in pooled investments	60,707,996	9,347,170
Accounts receivable, net of allowance of \$16,087,000 and \$12,630,000	108,645,662	82,589,514
Unbilled revenues	61,803,766	61,194,790
Energy contracts	1,825,246	5,496,378
Materials and supplies at average cost	18,885,987	18,724,736
Prepayments, interest receivable, and other	545,526	881,474
	252,414,183	178,234,062
OTHER ASSETS:		
Capitalized energy management services—net	124,315,501	116,277,404
Deferred power costs	-	100,000,000
Capitalized relicensing costs	16,013,434	14,328,345
Deferred costs—High Ross Agreement	49,194,941	40,321,500
Other deferred charges and assets—net	16,679,777	15,971,721
	206,203,653	286,898,970
TOTAL	\$ 2,026,183,065	\$ 2,060,552,691

See notes to financial statements.

LIABILITIES	2004	2003
LONG-TERM DEBT:		
Revenue bonds	\$1,537,246,000	\$1,521,526,000
Plus bond premium	40,848,307	29,810,512
Less bond discount	(745,410)	(1,570,959)
Less deferred charges on advanced refunding	(53,460,275)	(38,495,016)
Less revenue bonds—current portion	(64,596,000)	(53,820,000)
Note payable—City of Seattle	-	5,158,625
	<u>1,459,292,622</u>	<u>1,462,609,162</u>
NONCURRENT LIABILITIES:		
Accumulated provision for injuries and damages	9,507,214	10,491,426
Compensated absences	10,369,328	10,221,563
Long-term purchased power obligation	35,662,876	45,130,152
Less obligation—current portion	(10,705,000)	(10,300,000)
Other	175,887	174,356
	<u>45,010,305</u>	<u>55,717,497</u>
CURRENT LIABILITIES:		
Accounts payable and other	60,170,556	52,222,132
Accrued payroll and related taxes	6,018,469	4,949,166
Compensated absences	479,657	495,974
Accrued interest	16,226,097	19,797,650
Streetlight refund payable	19,998,457	-
Note payable—City of Seattle	5,158,625	70,000,000
Long-term debt—current portion	64,596,000	53,820,000
Purchased power obligation	10,705,000	10,300,000
Energy contracts	1,710,402	3,544,666
	<u>185,063,263</u>	<u>215,129,588</u>
DEFERRED CREDITS	<u>32,929,702</u>	<u>36,970,209</u>
Total liabilities	1,722,295,892	1,770,426,456
COMMITMENTS AND CONTINGENCIES (Note 13)		
EQUITY:		
Invested in capital assets—net of related debt	128,453,544	158,451,970
Restricted:		
Deferred power costs	-	100,000,000
Capitalized energy management services	35,821,624	28,944,953
Deferred costs—High Ross Agreement	21,884,942	22,114,834
Other	14,450,025	5,771,899
Unrestricted	103,277,038	(25,157,421)
	<u>303,887,173</u>	<u>290,126,235</u>
TOTAL	<u>\$2,026,183,065</u>	<u>\$2,060,552,691</u>

CITY OF SEATTLE – CITY LIGHT DEPARTMENT

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN EQUITY YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
OPERATING REVENUES:		
Retail power revenues	\$ 576,692,244	\$ 552,232,914
Short-term wholesale power revenues	163,264,753	137,650,966
Other power-related revenues	20,027,768	34,082,244
Other	<u>17,933,824</u>	<u>15,039,174</u>
	777,918,589	739,005,298
OPERATING EXPENSES:		
Long-term purchased power	229,416,360	240,505,211
Short-term wholesale power purchases	49,714,393	24,232,720
Amortization of deferred power costs	100,000,000	100,000,000
Other power expenses	7,074,410	21,139,577
Generation	20,283,509	20,210,903
Transmission	36,282,986	34,511,283
Distribution	40,972,862	39,116,032
Customer service	33,680,968	31,068,350
Energy management	11,237,221	11,014,634
Administrative and general	46,042,690	47,392,441
City of Seattle occupation tax	34,488,319	33,607,729
Other taxes	26,956,351	27,998,595
Depreciation	<u>73,852,844</u>	<u>69,270,029</u>
	<u>710,002,913</u>	<u>700,067,504</u>
Net operating income	67,915,676	38,937,794
NONOPERATING REVENUES (EXPENSES):		
Investment income	2,481,150	3,813,194
Interest expense	(73,823,812)	(73,934,677)
Amortization of refunding loss	(4,696,692)	(5,817,183)
Amortization of bond premium	3,004,828	3,804,504
Amortization of bond discount and issue costs	(789,223)	(1,107,332)
Other income—net	<u>1,805,246</u>	<u>36,192</u>
	<u>(72,018,503)</u>	<u>(73,205,302)</u>
Net loss before fees and grants	(4,102,827)	(34,267,508)
FEES AND GRANTS		
Capital contributions	10,580,789	22,089,096
Grants	<u>7,282,976</u>	<u>4,044,558</u>
	<u>17,863,765</u>	<u>26,133,654</u>
NET INCOME (LOSS)	13,760,938	(8,133,854)
EQUITY:		
Beginning of year	<u>290,126,235</u>	<u>298,260,089</u>
End of year	<u>\$ 303,887,173</u>	<u>\$ 290,126,235</u>

See notes to financial statements.

CITY OF SEATTLE – CITY LIGHT DEPARTMENT

STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
OPERATING ACTIVITIES:		
Cash received from customers and counterparties	\$ 791,002,215	\$ 751,992,693
Cash paid to suppliers, employees, and counterparties	(477,722,621)	(468,444,688)
Taxes paid	(71,039,601)	(68,610,633)
Net cash provided by operating activities	242,239,993	214,937,372
NONCAPITAL FINANCING ACTIVITIES:		
Repayment of Revenue Anticipation Note ("RAN")	-	(307,210,000)
Increase (decrease) in short-term borrowings—City of Seattle note	(70,000,000)	70,000,000
Interest paid on RAN	-	(7,324,362)
Interest paid on City of Seattle note	(489,277)	(216,284)
Grants received	6,503,504	2,235,516
Bonneville receipts for conservation augmentation	8,628,000	10,716,542
Payment to vendors on behalf of customers for conservation augmentation	(17,164,802)	(17,910,624)
Net cash used in noncapital financing activities	(72,522,575)	(249,709,212)
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Proceeds from long-term borrowing—net of discount	299,112,223	265,520,394
Payment to trustee for defeased bonds	(237,479,529)	(123,962,517)
Bond issue costs paid	(1,344,780)	(1,606,283)
Principal paid on long-term debt	(53,820,000)	(40,615,000)
Interest paid on long-term debt	(74,744,950)	(69,694,188)
Acquisition and construction of capital assets	(92,608,287)	(98,070,414)
Increase in other deferred assets and charges	(11,396,560)	(20,319,728)
Proceeds from sale of utility plant	2,364,182	709,000
Contributions in aid of construction	12,055,263	10,811,821
Net cash used in capital and related financing activities	(157,862,438)	(77,226,915)
INVESTING ACTIVITIES:		
Proceeds from investments	83,237,038	40,650,838
Purchases of investments	(41,880,917)	(108,896,905)
Interest received on investments	3,792,440	5,203,219
Net cash provided by (used in) investing activities	45,148,561	(63,042,848)
NET INCREASE (DECREASE) IN CASH AND EQUITY IN POOLED INVESTMENTS	57,003,541	(175,041,603)
CASH AND EQUITY IN POOLED INVESTMENTS:		
Beginning of year	100,534,868	275,576,471
End of year	\$ 157,538,409	\$ 100,534,868

(Continued)

CITY OF SEATTLE – CITY LIGHT DEPARTMENT

STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net operating income	\$ 67,915,676	\$ 38,937,794
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	73,852,844	69,270,029
Amortization of deferred credits	(5,770,236)	(3,442,161)
Amortization of deferred power costs and other charges	110,322,445	110,711,598
Change in:		
Accounts receivable	(25,458,138)	(3,974,205)
Unbilled revenues	(608,976)	(1,115,683)
Materials and supplies	(161,251)	1,722,974
Prepayments, interest receivable, and other	9,360	(3,954,078)
Other deferred charges and assets	333,715	7,395,688
Provision for injuries and damages and claims payable	1,948,141	3,181,299
Accounts payable, accrued payroll, and other	6,085,373	(19,924,530)
Compensated absences	131,448	51,179
Streetlight refund payable	19,998,457	-
Deferred credits	(6,358,865)	16,077,468
Total Adjustments	<u>174,324,317</u>	<u>175,999,578</u>
Net cash provided by operating activities	<u>\$ 242,239,993</u>	<u>\$ 214,937,372</u>
SUPPLEMENTAL DISCLOSURES OF NONCASH ACTIVITIES:		
In-kind capital contributions	<u>\$ 297,568</u>	<u>\$ 9,220,363</u>
Note payable incurred for purchase of property	<u>\$ -</u>	<u>\$ 5,565,000</u>

See notes to financial statements.

(Concluded)

CITY OF SEATTLE – CITY LIGHT DEPARTMENT

NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2004 AND 2003

1. OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The City Light Department (the “Department”) is the public electric utility of the City of Seattle (the “City”). The Department owns and operates certain generating, transmission, and distribution facilities and supplies electricity to approximately 372,818 customers. The Department supplies electrical energy to other City agencies at rates prescribed by City ordinances. The establishment of the Department’s rates is within the exclusive jurisdiction of the Seattle City Council. A requirement of Washington State law provides that rates must be fair, nondiscriminatory, and fixed to produce revenue adequate to pay for operation and maintenance expenses and to meet all debt service requirements payable from such revenue. The Department pays occupation taxes to the City based on total revenues.

The Department’s revenues were \$12.4 million and \$6.4 million for electrical energy and \$2 million and \$1.9 million for nonenergy services provided to other City departments in 2004 and 2003, respectively.

The Department receives certain services from other City departments and paid approximately \$33.9 million and \$35.7 million, respectively, in 2004 and 2003 for such services. Amounts paid include central cost allocations from the City’s general fund for services received such as treasury services, debt management, risk management, personnel, payroll, purchasing, technology services, facilities, facilities maintenance, vehicles, City Auditor, other administrative services, and lease of office facilities.

Accounting Standards—The accounting and reporting policies of the Department are regulated by the Washington State Auditor’s Office, Division of Municipal Corporations, and are based on the Uniform System of Accounts prescribed for public utilities and licensees by the Federal Energy Regulatory Commission (“FERC”). The financial statements are also prepared in conformity with accounting principles generally accepted in the United States of America as applied to governmental units. The Governmental Accounting Standards Board (“GASB”) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles. The Department has applied all applicable GASB pronouncements as well as the following pronouncements, except for those that conflict with or contradict GASB pronouncements: Statements and Interpretations of the Financial Accounting Standards Board (“FASB”), Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures. The more significant of the Department’s accounting policies are described below.

In June 2001, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 143, *Accounting for Asset Retirement Obligations*, which addresses financial accounting and reporting for legal or contractual obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement requires the recording of the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the associated costs of the asset retirement obligation will be capitalized as part of the carrying amount of the related long-lived asset. The liability will be accreted to its present value each period and the related capitalized costs will be depreciated over the useful life of the related asset. Upon retirement of the asset, the Department will either settle the retirement obligation for its recorded amount or incur a gain or loss. The adoption of this statement on January 1, 2003 did not have a material effect on the Department’s financial position or operations.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. The Department has entered into certain forward contracts to purchase or sell power that may no longer meet the normal purchases and sales exception in accordance with the provisions of SFAS No. 149. This statement requires these types of forward contracts to purchase or sell power, which were entered into on or after July 1, 2003, be recorded as assets or liabilities at market value with an offsetting regulatory asset or liability as allowed under SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. The adoption of this statement did not have a material effect on the Department's financial position or operations.

In July 2003, the Emerging Issues Task Force ("EITF") reached consensus on Issue No. 03-11, *Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not "Held for Trading Purposes" as Defined in EITF Issue No. 02-3*. This EITF issue requires that revenues and expenses from the Department's settled energy contracts that are "booked out" (not physically delivered) should be reported on a net basis as part of operating revenues. The adoption of this statement did not have a material effect on the Department's financial position or operations.

In March 2003, the GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures*. This statement establishes and modifies disclosure requirements related to investment risks: credit risk (including custodial credit risk and concentrations of credit risk), interest rate risk, and foreign currency risk. This statement also establishes and modifies disclosure requirements for deposit risks: custodial credit risk and foreign currency risk. The requirements of this statement are effective for the Department's financial statements for periods beginning after June 15, 2004 (January 1, 2005). The Department does not expect a material impact on its financial position or results of operations from adoption of this statement.

GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This statement also clarifies and establishes accounting requirements for insurance recoveries. The requirements of this statement are effective for the Department's financial statements for periods beginning after December 15, 2004 (January 1, 2005). The Department does not expect a material impact on its financial position or results of operations from adoption of this statement.

In July 2004, the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This statement establishes and modifies disclosure requirements for reporting by administrators or trustees of other postemployment benefits ("OPEB") plan assets or by employers or sponsors that include OPEB plan assets as trust or agency funds in financial reports. The requirements of this Statement are effective for the Department's financial statements for periods beginning after December 15, 2006 (January 1, 2007). The Department is in the process of determining the impact on its financial position and results of operation from adoption of this statement.

Utility Plant—Utility plant is recorded at original cost, which includes both direct costs of construction or acquisition and indirect costs, including an allowance for funds used during construction. Property constructed with capital fees received from customers is included in utility plant. Capital fees totaled \$10.6 million in 2004 and \$22.1 million in 2003. Provision for depreciation is made using the straight-line method based upon estimated economic lives, which range from three to 50 years, of related operating assets. The Department uses a half-year convention method on the assumption that additions and replacements are placed in service at mid-year. The composite depreciation rate was approximately 3.3% in 2004 and 3.2% in 2003. When operating plant assets are retired, their original cost together with

removal costs, less salvage, is charged to accumulated depreciation. The cost of maintenance and repairs is charged to expense as incurred, while the cost of replacements and betterments is capitalized. The Department periodically reviews long-lived assets for impairment to determine whether any events or circumstances indicate the carrying value of the assets may not be recoverable. No impairment was identified in 2004 or 2003.

Restricted Assets—In accordance with the Department’s bond resolutions, state law, or other agreements, separate restricted assets have been established. These assets are restricted for specific purposes, including the establishment of the Municipal Light & Power (“ML&P”) Bond Reserve Account, financing of the Department’s ongoing Capital Improvement Program, and other purposes.

Compensated Absences—Permanent employees of the Department earn vacation time in accordance with length of service. A maximum of 480 hours may be accumulated and, upon termination, employees are entitled to compensation for unused vacation. At retirement, employees receive compensation equivalent to 25% of their accumulated sick leave. The Department accrues all costs associated with compensated absences, including payroll taxes.

Accounts Payable and Other—The composition of accounts payable and other at December 31 is as follows:

	2004	2003
Vouchers payable	\$ 7,486,533	\$ 7,471,873
Power accounts payable	29,871,492	24,540,593
Interfund payable	5,265,504	5,892,236
Taxes payable	8,367,304	9,528,936
Claims payable—current	6,098,468	3,166,115
Guarantee deposit and contract retainer	2,909,548	1,502,526
Other accounts payable	<u>171,707</u>	<u>119,853</u>
	<u>\$ 60,170,556</u>	<u>\$ 52,222,132</u>

Revenue Recognition—Service rates are authorized by City ordinances. Billings are made to customers on a monthly or bimonthly basis. Revenues for energy delivered to customers between the last billing date and the end of the year are estimated and reflected in the accompanying financial statements under the caption unbilled revenues.

The Department’s customer base accounted for electric energy sales as follows:

	2004	2003
Residential	34.5 %	36.1 %
Non-residential	<u>65.5</u>	<u>63.9</u>
	<u>100.0 %</u>	<u>100.0 %</u>

Administrative and General Overhead Applied—Administrative and general costs are allocated to construction work-in-progress, major data processing systems development, programmatic conservation, relicensing mitigation projects, and billable operations and maintenance activities based on rates

established by cost studies and totaled \$42.3 million and \$40.9 million in 2004 and 2003, respectively. Total administration and general costs were \$88.4 million and \$88.3 million in 2004 and 2003, respectively, prior to application of overhead.

Interest Charged to Construction—Interest is charged for funds used during the construction of plant assets and to nonbillable construction work-in-progress. Interest charged represents the estimated costs of financing construction projects and is computed using the Department’s long-term borrowing rate. The allowance totaled \$3.5 million and \$4.3 million in 2004 and 2003, respectively, and is reflected as a reduction of interest expense in the statements of revenues, expenses, and changes in equity.

Nonexchange Transactions—Capital contributions and grants in the amount of \$17.9 million and \$26.1 million are reported for 2004 and 2003, respectively, on the statements of revenues, expenses, and changes in equity as nonoperating revenues from nonexchange transactions. In-kind capital contributions are recognized at fair value and are generally based either on the internal engineer’s estimate of the current cost of comparable plant in service or the donor’s actual cost.

Use of Estimates—The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect amounts reported in the financial statements. The Department used significant estimates in determining reported unbilled revenues, energy contract assets and liabilities, accumulated provision for injuries and damages, allowance for doubtful accounts, accrued sick leave, and other contingencies. Actual results may differ from those estimates.

Significant Risk and Uncertainty—The Department is subject to certain business risks that could have a material impact on future operations and financial performance. These risks include prices on the wholesale markets for short-term power transactions; interest rates; water conditions, weather, and natural disaster related disruptions; terrorism; collective bargaining labor disputes; fish and other Endangered Species Act (“ESA”) issues; Environmental Protection Agency (“EPA”) regulations; federal government regulations or orders concerning the operations, maintenance, and/or licensing of hydroelectric facilities; other governmental regulations; restructuring of the electrical utility industry; and the costs of constructing transmission facilities that may be incurred as part of a northwest regional transmission system, and related effects of this system on transmission rights, transmission sales, the value of surplus energy, and governance.

Reclassifications—Certain 2003 account balances have been reclassified to conform to the 2004 presentation.

2. UTILITY PLANT

Utility plant in service at original cost, excluding land, at December 31, 2004 consists of:

	Hydraulic Production	Transmission	Distribution	General	Total
Beginning balance	\$ 558,719,929	\$ 145,980,758	\$ 1,139,408,622	\$ 308,571,436	\$ 2,152,680,745
Capital acquisitions	21,961,354	1,187,005	62,987,671	16,314,017	102,450,047
Dispositions	(2,142,454)	(293,036)	(2,623,685)	(777,529)	(5,836,704)
Transfers and adjustments	-	3,332	194,233	14,393	211,958
	578,538,829	146,878,059	1,199,966,841	324,122,317	2,249,506,046
Less accumulated depreciation	(289,063,621)	(65,638,978)	(437,756,656)	(188,280,922)	(980,740,177)
Ending balance	<u>\$ 289,475,208</u>	<u>\$ 81,239,081</u>	<u>\$ 762,210,185</u>	<u>\$ 135,841,395</u>	<u>\$ 1,268,765,869</u>

Utility plant in service at original cost, excluding land, at December 31, 2003, consists of:

	Hydraulic Production	Transmission	Distribution	General	Total
Beginning balance	\$ 527,022,003	\$ 139,951,608	\$ 1,068,429,863	\$ 297,080,941	\$ 2,032,484,415
Capital acquisitions	36,972,921	6,406,711	68,394,546	16,843,145	128,617,323
Dispositions	(5,279,046)	(295,449)	(2,637,960)	(5,352,650)	(13,565,105)
Transfers and adjustments	<u>4,051</u>	<u>(82,112)</u>	<u>5,222,173</u>	<u>-</u>	<u>5,144,112</u>
	558,719,929	145,980,758	1,139,408,622	308,571,436	2,152,680,745
Less accumulated depreciation	<u>(279,420,331)</u>	<u>(62,863,342)</u>	<u>(410,090,161)</u>	<u>(162,604,679)</u>	<u>(914,978,513)</u>
Ending balance	<u>\$ 279,299,598</u>	<u>\$ 83,117,416</u>	<u>\$ 729,318,461</u>	<u>\$ 145,966,757</u>	<u>\$ 1,237,702,232</u>

3. CASH AND EQUITY IN POOLED INVESTMENTS AND INVESTMENTS

Cash and Equity in Pooled Investments and Investments—The City pools and invests all temporary cash surpluses for City departments. The funds of the participating departments use the cash pool similar to a demand deposit account. Departments may deposit cash at any time and can also withdraw cash out of the pool without prior notice or penalty. Therefore, the individual participating funds account for the cash pool as Cash and Equity in Pooled Investments for cash flow reporting purposes. Investments are recorded at fair value based upon quoted market prices. Interest earned on the City’s pooled investments and adjustments to fair value are prorated to the individual funds at the end of each month on the basis of their average daily cash balance during the preceding month.

In accordance with the Revised Code of Washington (RCW) 35.39.032, the City has an established Investment Policy by which it manages all temporary cash surpluses and purchases investments authorized as indicated by RCW 35.39.030 and RCW 35.39.034. The City is authorized to purchase U.S. Treasury and government agency securities; certificates of deposits and other investment deposits issued by Washington State depositories that qualify under the Washington State Deposit Protection Act as defined by RCW 39.58; bankers’ acceptances purchased in the secondary market; commercial paper purchased in the secondary market and having received the highest rating by at least two nationally recognized rating agencies; repurchase and reverse repurchase agreements with “primary dealers” that have executed master repurchase agreements; mortgage-backed securities; derivative-based securities; and participation in the State Treasurer’s local government investment pool. According to City policy, securities purchased will have a maximum maturity of no longer than 15 years, and the average maturity of all securities owned should be no longer than five years. Banks or trust companies acting as the City’s agents hold most of the City’s investments in the City’s name, with respect to credit risk as defined in GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*.

The City is also allowed under state law to make securities lending transactions under the authority of RCW 41.28.005 and the Seattle Municipal Code 4.36.130. Securities lent must be collateralized with cash in the amount of 102% the market value of the loaned securities. There were securities lending transactions during 2004 and 2003. There were no securities lending program transactions outstanding at year-end 2004 or 2003. All transactions are executed with authorized security dealers, financial institutions, or securities lending agents on a delivery versus payment basis.

The City’s residual investment pool did not include reverse repurchase agreements at the end of 2004 or 2003; the City did not invest in such instruments during 2004 or 2003. Derivative-based securities were owned by the cash pool during 2004 and 2003 and at both year-ends. These securities were callable U.S. government agency instruments.

The first \$100,000 of bank deposits is federally insured. The Washington State Public Deposit Protection Commission ("PDPC") collateralizes deposits in excess of \$100,000. The PDPC is a multiple financial institution collateral pool. There is no provision for the PDPC to make additional pro rata assessments if needed to cover a loss. Therefore, the PDPC protection is of the nature of collateral, not of insurance.

Department dedicated securities with maturities exceeding three months at time of purchase are reported at fair value on the balance sheets; the net increase (decrease) in the fair value of those investments is reported as part of investment income.

Cash and cash equivalents included in cash and equity in pooled investments at December 31 consist of:

	2004	2003
Restricted assets:		
Municipal Light and Power Bond Reserve Account	\$ 20,436,614	\$ 14,486,404
Bond proceeds and other	1,250,033	1,348,695
Special deposits and other	<u>6,928,997</u>	<u>4,158,641</u>
	28,615,644	19,993,740
Current assets	<u>14,551,483</u>	<u>1,700,368</u>
	<u>\$43,167,127</u>	<u>\$21,694,108</u>

At December 31, changes in the fair value of investments resulted in an unrealized loss of \$1.0 million for 2004 and an unrealized loss of \$1.7 million for 2003.

Equity in pooled investments and U.S. government securities are reported at fair values based on quoted market prices for those or similar securities and are as follows at December 31:

	2004	2003
Restricted assets:		
Municipal Light & Power Bond Reserve Account:		
Equity in pooled investments	\$ 64,245,770	\$ 65,136,266
Bond proceeds and other:		
Equity in pooled investments	<u>3,968,999</u>	<u>6,057,692</u>
	68,214,769	71,193,958
Current assets:		
Equity in pooled investments	<u>46,156,513</u>	<u>7,646,802</u>
	<u>\$ 114,371,282</u>	<u>\$78,840,760</u>

4. ACCOUNTS RECEIVABLE

Accounts receivable at December 31 consist of:

	Retail Power	Wholesale Power	Fees and Other	Interfund	Due from Other Governments	Total
2004:						
Accounts receivable	\$ 60,641,402	\$ 26,453,326	\$ 7,394,914	\$ 20,729,775	\$ 9,513,245	\$ 124,732,662
Less allowance for doubtful accounts	<u>(12,335,000)</u>	<u>(2,550,000)</u>	<u>(1,202,000)</u>	<u>-</u>	<u>-</u>	<u>(16,087,000)</u>
	48,306,402	23,903,326	6,192,914	20,729,775	9,513,245	108,645,662
2003:						
Accounts receivable	\$ 59,257,341	\$ 23,897,296	\$ 5,125,240	\$ 1,458,279	\$ 5,481,358	\$ 95,219,514
Less allowance for doubtful accounts	<u>(8,850,000)</u>	<u>(2,570,000)</u>	<u>(1,210,000)</u>	<u>-</u>	<u>-</u>	<u>(12,630,000)</u>
	<u>\$ 50,407,341</u>	<u>\$ 21,327,296</u>	<u>\$ 3,915,240</u>	<u>\$ 1,458,279</u>	<u>\$ 5,481,358</u>	<u>\$ 82,589,514</u>

5. SHORT-TERM POWER CONTRACTS AND DERIVATIVE INSTRUMENTS

The Department enters into short-term forward contracts to purchase or sell energy. Under these forward contracts, the Department commits to purchase or sell a specified amount of energy at a specified time, or during a specified time in the future. Certain of the forward contracts are considered derivative instruments as they may be net settled without physical delivery. These derivative instruments, along with other short-term power transactions, are entered into solely for the purpose of managing the Department's resources to meet load requirements. Gains and losses resulting from the fair valuation of the derivative instruments are deferred pursuant to SFAS No. 71 (see Notes 10 and 11). Power transactions in response to forecasted seasonal resource and demand variations require approval by the Department's Risk Management Committee. Fluctuations in annual precipitation levels and other weather conditions materially affect the energy output from the Department's hydroelectric facilities and some of its long-term purchased hydroelectric power agreements. Demand fluctuates with weather and local economic conditions. Accordingly, short-term power transactions required to manage resources to meet the Department's load and dispose of surplus energy may vary from year to year.

6. LONG-TERM AND SHORT-TERM DEBT

At December 31, the Department's long-term and short-term debt consisted of the following:

LONG-TERM				2004	2003
Prior Lien Bonds:		Fixed Rate	Year Due		
2004	ML&P Improvement and Refunding Revenue Bonds	3.000% to 5.250%	2029	\$ 284,855,000	\$ -
2003	ML&P Improvement and Refunding Revenue Bonds	4.000% to 6.000%	2028	241,935,000	251,850,000
2002	ML&P Refunding Revenue Bonds	3.000% to 4.500%	2014	80,195,000	85,275,000
2001	ML&P Improvements and Refunding Revenue Bonds	5.000% to 5.500%	2026	499,965,000	503,700,000
2000	ML&P Revenue Bonds	4.500% to 5.625%	2025	98,830,000	98,830,000
1999	ML&P Revenue Bonds	5.000% to 6.000%	2024	19,750,000	158,000,000
1998B	ML&P Revenue Bonds	4.750% to 5.000%	2024	87,385,000	90,000,000
1998A	ML&P Refunding Revenue Bonds	4.500% to 5.000%	2020	101,380,000	102,120,000
1997	ML&P Revenue Bonds	5.000% to 5.125%	2022	28,100,000	29,070,000
1996	ML&P Revenue Bonds	5.250% to 5.625%	2021	2,055,000	28,230,000
1995B	ML&P Revenue Bonds	4.050% to 4.800%	2005	456,000	456,000
1995A	ML&P Revenue Bonds	5.000% to 5.700%	2020	-	53,875,000
1994	ML&P Revenue Bonds	6.00%	2004	-	3,450,000
1993	ML&P Revenue and Refunding Revenue Bonds	2.200% to 5.500%	2018	-	20,215,000
				1,444,906,000	1,425,071,000
Subordinate Lien Bonds:					
1996	ML&P Adjustable Rate Revenue Bonds	variable rates	2021	17,740,000	18,455,000
1993	ML&P Adjustable Rate Revenue Bonds	variable rates	2018	16,900,000	17,800,000
1991B	ML&P Adjustable Rate Revenue Bonds	variable rates	2016	15,100,000	16,500,000
1991A	ML&P Adjustable Rate Revenue Bonds	variable rates	2016	25,000,000	25,000,000
1990	ML&P Adjustable Rate Revenue Bonds	variable rates	2015	17,600,000	18,700,000
				92,340,000	96,455,000
City of Seattle:					
2003	Note payable	5.000%	2005	-	5,158,625
Total long-term debt				<u>\$ 1,537,246,000</u>	<u>\$ 1,526,684,625</u>
SHORT-TERM					
City of Seattle:					
2003	Note payable	5.000%	2005	\$ 5,158,625	\$ -
2003	Short-term borrowings—City of Seattle	variable	2004	-	70,000,000
Total short-term debt				<u>\$ 5,158,625</u>	<u>\$ 70,000,000</u>

The Department had the following activity in long-term debt during 2004:

	Balance at December 31, 2003	Additions	Reductions	Balance at December 31, 2004	Current Portion
Prior Lien Bonds	\$ 1,425,071,000	\$ 284,855,000	\$(265,020,000)	\$ 1,444,906,000	\$ 60,151,000
Subordinate Lien Bonds	96,455,000	-	(4,115,000)	92,340,000	4,445,000
Note payable—City of Seattle	5,158,625	-	(5,158,625)	-	5,158,625
	<u>\$ 1,526,684,625</u>	<u>\$ 284,855,000</u>	<u>\$(274,293,625)</u>	<u>\$ 1,537,246,000</u>	<u>\$ 69,754,625</u>

Prior Lien Bonds—In December 2004, the Department issued \$284.9 million in ML&P Improvement and Refunding Revenue Bonds that bear interest at rates ranging from 3.00% to 5.25% and mature serially from August 1, 2005 through 2025. Term bonds mature on August 1, 2029. The arbitrage yield for the 2004 bonds is 4.055%. Arbitrage yield, when used in computing the present worth of all payments of principal and interest on the bonds, produces an amount equal to the issue price of the bonds. Proceeds were used to finance certain capital improvements and conservation programs and to defease certain outstanding 1995A, 1996, and 1999 series prior lien bonds. The debt service on the improvement and refunding bonds requires a cash flow of \$448.3 million, including \$163.4 million in interest. The difference between the cash flows required to service the old and the new debt and complete the refunding totaled \$22.4 million, and the aggregate economic gain totaled \$12.1 million at net present value. The loss on refunding was \$19.7 million and is being amortized using the effective interest method over the life of the refunded bonds. The unamortized balance of the loss on refunding at December 31, 2004 was \$19.6 million.

In August 2003, the Department issued \$251.8 million in ML&P Improvement and Refunding Revenue Bonds that bear interest at rates ranging from 4.00% to 6.00% and mature serially from November 1, 2004 through 2025. Term bonds mature on November 1, 2028. The arbitrage yield for the 2003 bonds was 4.335%. Proceeds were used to finance certain capital improvements and conservation programs and to defease certain outstanding 1993 series prior lien bonds. The debt service on the improvement and refunding bonds requires a cash flow of \$393.4 million, including \$141.5 million in interest. The difference between the cash flows required to service the old and the new debt and complete the refunding totaled \$5.8 million, and the aggregate economic gain totaled \$5.4 million at net present value. The loss on refunding was \$15.0 million and is being amortized using the effective interest method over the life of the new bonds. The unamortized balance of the loss on refunding at December 31, 2004 and 2003 was \$11.8 million and \$14.0 million, respectively.

Future debt service requirements for prior lien bonds are as follows:

Year Ending December 31	Principal Redemptions	Interest Requirements	Total
2005	\$ 60,151,000	\$ 66,925,532	\$ 127,076,532
2006	58,660,000	69,569,752	128,229,752
2007	61,450,000	66,766,240	128,216,240
2008	64,620,000	63,596,352	128,216,352
2009	67,990,000	60,235,645	128,225,645
2010 – 2014	345,015,000	250,039,501	595,054,501
2015 – 2019	351,425,000	159,859,491	511,284,491
2020 – 2024	317,000,000	74,062,462	391,062,462
2025 – 2029	<u>118,595,000</u>	<u>10,413,599</u>	<u>129,008,599</u>
	<u>\$1,444,906,000</u>	<u>\$ 821,468,574</u>	<u>\$2,266,374,574</u>

The Department is required by ordinance to fund reserves for prior lien bond issues in an amount equal to the lesser of (a) the maximum annual debt service on all bonds secured by the reserve account or (b) the maximum amount permitted by the Internal Revenue Code (“IRC”) of 1986 as a reasonably required reserve or replacement fund. Upon issuance of the 2004 bonds, the maximum annual debt service on prior lien bonds was \$128.2 million due in 2006. The maximum amount permitted by the IRC remained at \$113.3 million. At December 31, 2004 and 2003, the balance in the reserve account was \$87 million and \$79.6 million at fair value, respectively. The reserve must be fully funded by December 1, 2009.

In addition to the 2004 and 2003 refunding revenue bonds, the Department has previously issued several refunding revenue bonds for the purpose of defeasing certain outstanding prior lien bonds. Refunding revenue bonds were issued in 2002, 2001, 1998, and 1993. Proceeds from the refunding bonds were placed in separate irrevocable trusts to provide for all future debt service payments on the bonds defeased. Accordingly, neither the assets of the respective trust accounts nor the liabilities for the defeased bonds are reflected in the Department’s financial statements. The bonds defeased in 2003 and 2002 were called in full on November 1, 2003. The bonds defeased in 1998 were called in full on July 1, 2004. The bonds defeased in 2004 and 1993 had outstanding principal balances of \$215.3 million and \$2.2 million, respectively, as of December 31, 2004. Funds held in the respective trust accounts on December 31, 2004, are sufficient to service and redeem the defeased bonds.

Subordinate Lien Bonds—The Department is authorized to issue a limited amount of adjustable rate revenue bonds, which are subordinate to prior lien bonds with respect to claim on revenues. Subordinate lien bonds may be issued to the extent that the new bonds will not cause the aggregate principal amount of such bonds then outstanding to exceed the greater of \$70 million or 15% of the aggregate principal amount of prior lien bonds then outstanding. Subordinate bonds may be remarketed daily, weekly, short-term, or long-term and may be converted to prior lien bonds when certain conditions are met.

Future debt service requirements on the subordinate lien bonds, based on 2004 end of year actual interest rates ranging from 1.12% to 2.35% through year 2021, are as follows:

Year Ending December 31	Principal Redemptions	Interest Requirements	Total
2005	\$ 4,445,000	\$ 1,393,100	\$ 5,838,100
2006	4,775,000	1,358,954	6,133,954
2007	5,305,000	1,277,524	6,582,524
2008	5,840,000	1,189,644	7,029,644
2009	6,270,000	1,091,626	7,361,626
2010 – 2014	39,125,000	3,791,621	42,916,621
2015 – 2019	23,815,000	962,874	24,777,874
2020 – 2021	<u>2,765,000</u>	<u>53,469</u>	<u>2,818,469</u>
	<u>\$92,340,000</u>	<u>\$11,118,812</u>	<u>\$103,458,812</u>

Revenue Anticipation Notes—In November 2002, the Department issued \$125.0 million in ML&P Revenue Anticipation Notes (“RANs”) at an interest rate of 2.50% with an arbitrage yield of 1.49%. The 2002 RANs matured in November 2003.

In March 2001, the Department issued \$182.2 million in ML&P RANs. \$136.7 million of the 2001 RANs had an interest rate of 4.50%, and \$45.5 million had an interest rate of 5.25%. The arbitrage yield of the 2001 RANs was 3.75%. The 2001 RANs matured in March 2003.

Both RANs issued were special limited obligations of the Department payable from and secured by gross revenues. Proceeds were used to finance operating expenses for each respective year. The RANs were on a lien subordinate to prior lien bonds and subordinate lien bonds.

Fair Value—The fair value of the Department’s bonds and RANs is estimated based on the quoted market prices for the same or similar issues or on the current rates offered to the Department for debt of the same remaining maturities. Carrying amounts and fair values are as follows at December 31:

	2004		2003	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Long-term debt:				
Prior lien bonds	\$1,485,232,262	\$1,530,156,972	\$1,453,551,784	\$1,528,392,143
Subordinate lien bonds	<u>92,116,635</u>	<u>92,340,000</u>	<u>96,213,769</u>	<u>96,455,000</u>
	<u>\$1,577,348,897</u>	<u>\$1,622,496,972</u>	<u>\$1,549,765,553</u>	<u>\$1,624,847,143</u>

Amortization—Bond issue costs, discounts, and premiums are amortized using the effective interest method over the term of the bonds.

The excess of costs incurred over the carrying value of bonds refunded on early extinguishment of debt is amortized as a component of interest expense using both the straight-line and effective interest methods over the terms of the issues to which they pertain. Deferred refunding costs amortized to

interest expense totaled \$4.7 million in 2004 and \$5.8 million in 2003. Deferred refunding costs in the amount of \$53.5 million and \$38.5 million are reported as a component of long-term debt in the 2004 and 2003 balance sheets, respectively.

Note Payable—In 2003, the Department purchased real estate property for a potential future substation from the City of Seattle Department of Parks and Recreation at a price of \$5.6 million, financed with a note payable to the Department of Parks and Recreation at 5%, maturing in July 2005. Debt service requirements remaining for this note payable are:

Year Ending December 31	Principal Redemptions	Interest Requirements	Total
2005	\$ 5,158,625	\$ 257,932	\$ 5,416,557

Short-Term Borrowings—In late December 2001, the City of Seattle authorized an interfund loan (note payable) to the Department from the City’s Consolidated (Residual) Cash Portfolio in an amount up to \$110.0 million, of which \$100 million was outstanding as of December 31, 2001. The purpose of the note payable was for working capital and it was due on or before March 31, 2003. The loan was repaid on January 1, 2002 and was carried as a negative operating cash balance during part of 2002. The loan was repaid in November 2002 with the 2002 RAN proceeds and was carried as a negative operating cash balance until maturity in March 2003.

In 2003, Ordinance No. 121154 provided for a new interfund loan or note payable up to \$50 million for working capital repayable on or before August 31, 2003. The same ordinance authorized an additional interfund loan up to \$100 million beginning October 31, 2003 and expiring in December 31, 2004. The amount outstanding as of December 31, 2003 was \$70 million. The interest rate for the note payable for each month during 2004 and 2003 was equal to the rate of return earned for each respective month by the City’s Consolidated (Residual) Cash Portfolio. The 2003 note payable was carried as a negative operating cash balance until the cash balance was restored from operations in May 2004.

7. SEATTLE CITY EMPLOYEES’ RETIREMENT SYSTEM

The Seattle City Employees’ Retirement System (“SCERS”) is a single-employer defined benefit, public employee retirement system, covering employees of the City and administered in accordance with Chapter 41.28 of the Revised Code of Washington and Chapter 4.36 of the Seattle Municipal Code. SCERS is a pension trust fund of the City.

All employees of the City are eligible for membership in SCERS with the exception of uniformed police and fire personnel who are covered under a retirement system administered by the state of Washington. Employees of Metro and the King County Health Department who established membership in SCERS when these organizations were City departments were allowed to continue their SCERS membership. As of January 1, 2004, there were 4,876 retirees and beneficiaries receiving benefits and 8,382 active members of SCERS. In addition, 1,560 vested terminated employees were entitled to future benefits.

SCERS provides retirement, death, and disability benefits. Retirement benefits vest after five years of credited service, while death and disability benefits vest after 10 years of service. Retirement benefits are calculated as 2% multiplied by years of creditable service, multiplied by average salary, based on the highest 24 consecutive months, excluding overtime. The benefit is actuarially reduced for early retirement. Future increases in the cost-of-living adjustments are available to current and future retired members only if SCERS attains at least a 95% funding level.

Actuarially recommended contribution rates both for members and for the employer were 8.03% of covered payroll during 2004 and 2003.

Under the authority of the state and City, SCERS operates a securities lending program, and there were transactions during 2004 and 2003. SCERS has had no losses resulting from a default, and SCERS did not have negative credit exposure at December 31, 2004 or 2003.

SCERS issues stand-alone financial statements that may be obtained by writing to the Seattle City Employees' Retirement System, 801 Third Avenue, Suite 300, Seattle, Washington 98104; telephone: (206) 386-1292.

Employer contributions for the City were \$36.7 million and \$34.2 million in 2004 and 2003, respectively, and the annual required contributions were made in full.

Actuarial Data

Valuation date	January 1, 2004
Actuarial cost method	Entry age
Amortization method	Level percent
Remaining amortization period	30.2 years
Amortization period	Open
Asset valuation method	Market

Actuarial Assumptions*

Percentage

Investment rate of return	7.75%
Projected general wage increases	4.00
Cost-of-living year-end bonus dividend	0.67

* Includes price inflation at 3.5%.

Schedule of funding progress for SCERS (dollar amounts in millions):

Actuarial Valuation Date	Actuarial Value of Assets	Actuarial Accrued Liabilities ("AAL") (1)	Unfunded AAL ("UAAL") (2)	Funding Ratio (a/b)	Covered Payroll (3)	UAAL or (Excess) as a Percentage of Covered Payroll ((b-a)/c)
January 1,	(a)	(b)	(b-a)		(c)	
2001(4)	\$ 1,493.1	\$ 1,490.3	\$ (2.8)	100.2 %	\$ 405.0	(0.7)%
2002	1,383.7	1,581.4	197.7	87.5	405.1	48.8
2004	1,527.5	1,778.9	251.4	85.9	424.7	59.2

- (1) Actuarial present value of benefits less actuarial present value of future normal costs based on entry age actuarial cost method.
- (2) Actuarial accrued liabilities less actuarial value of assets; funding excess if negative.
- (3) Covered payroll includes compensation paid to all active employees on which contributions are calculated.
- (4) Information for January 1, 2001 was provided by an actuarial study, rather than a full valuation.

8. DEFERRED COMPENSATION

The Department's employees may contribute to the City's Voluntary Deferred Compensation Plan (the "Plan"). The Plan, available to City employees and officers, permits participants to defer a portion of their salary until future years. The Plan administrator is Prudential Retirement effective 2004 and was Fidelity Investments in 2003. The deferred compensation is paid to participants and their beneficiaries upon termination, retirement, death, or unforeseeable emergency.

Effective January 1, 1999, the Plan became an eligible deferred compensation plan under Section 457 of the IRC of 1986, as amended, and a trust exempt from tax under IRC Sections 457(g) and 501(a). The Plan is operated for the exclusive benefit of participants and their beneficiaries. No part of the corpus or income of the Plan shall revert to the City or be used for, or diverted to, purposes other than the exclusive benefit of participants and their beneficiaries.

The Plan is not reported in the financial statements of the City or the Department.

It is the opinion of the City's legal counsel that the City has no liability for investment losses under the Plan. Participants direct the investment of their money into one or more options provided by the Plan and may change their selection from time to time. By enrolling in the Plan, participants accept and assume all risks inherent in the Plan and its administration.

9. LONG-TERM PURCHASED POWER, EXCHANGES, AND TRANSMISSION

Bonneville Power Administration—The Department purchases electric energy from the U.S. Department of Energy, Bonneville Power Administration ("Bonneville") under the Block and Slice Power Sales Agreement, a 10-year contract that expires September 30, 2011. The agreement provides a block of power shaped to the Department's monthly net requirements, defined as the difference between projected monthly load and firm resources available to serve that load. Additional amounts of power will be purchased and received throughout the term of the contract under the Slice portion of the contract. The terms of the Slice product specify that the Department will receive a fixed percentage (4.6676%) of the actual output of the Federal Columbia River Power System. The cost of Slice power is based on the Department's same percentage (4.6676%) of the expected costs of the system and is subject to true-up adjustments based on actual costs. Amendments to the contract through September 2003 provide that Bonneville will pay the Department for energy savings realized through specified programs.

Lucky Peak—In 1984, the Department entered into a purchase power agreement with four irrigation districts to acquire 100% of the net output of a hydroelectric facility that began commercial operation in 1988 at the existing Army Corps of Engineers Lucky Peak Dam on the Boise River near Boise, Idaho. The irrigation districts are owners and license holders of the project, and the FERC license expires in 2030. The agreement, which expires in 2038, obligates the Department to pay all ownership and operating costs, including debt service, over the term of the contract, whether or not the plant is operating or operable. To properly reflect its rights and obligations under this agreement, the Department includes as an asset and liability the outstanding principal of the project's debt, net of the balance in the project's reserve account.

British Columbia—Ross Dam—In 1984, an agreement was reached between the Province of British Columbia and the City under which British Columbia will provide the Department with power equivalent to that which would result from an addition to the height of Ross Dam. The power is to be received for 80 years, and delivery of power began in 1986. In addition to the direct costs of power under the agreement, the Department incurred costs of approximately \$8.0 million in prior years related

to the proposed addition and was obligated to help fund the Skagit Environmental Endowment Commission through four annual \$1 million payments. These costs were deferred and are being amortized to purchased power expense over 35 years.

Power received and expenses under these and other long-term purchased power agreements are as follows:

Year Ending December 31	2004 Expense	2003 Expense	2004 aaMW*	2003 aaMW*
Bonneville Block	\$ 33,696,129	\$ 38,102,290	392.8	390.9
Bonneville Slice	<u>97,278,651</u>	<u>118,985,217</u>	<u>137.8</u>	<u>147.1</u>
	130,974,780	157,087,507	530.6	538.0
Lucky Peak	16,783,152	12,239,433	31.3	33.4
British Columbia—Ross Dam	13,370,826	13,358,439	34.8	36.0
City of Klamath Falls	42,022,348	36,280,909	81.8	74.7
State Line Wind	18,254,080	12,876,636	39.7	24.7
Pend Oreille County Public Utility District	1,500,570	1,278,453	6.7	5.4
Grant County Public Utility District	2,450,048	2,611,925	36.0	35.5
Grand Coulee Project Hydro Authority	5,679,435	4,830,362	28.9	26.9
Bonneville South Fork Tolt billing credit	(3,047,299)	(2,965,271)	-	-
British Columbia—Boundary Encroachment	(1,197,160)	(685,118)	1.5	1.6
Exchange energy	2,358,648	2,806,252	12.4	12.4
Other	<u>266,932</u>	<u>785,684</u>	<u>0.7</u>	<u>4.6</u>
	<u>\$ 229,416,360</u>	<u>\$ 240,505,211</u>	<u>804.4</u>	<u>793.2</u>

*Average annual megawatt hours (aaMW)

Estimated Future Payments Under Purchased Power and Transmission Contracts—The Department’s estimated payments under its contracts with Bonneville, the public utility districts, irrigation districts, Lucky Peak Project, British Columbia – High Ross Agreement, Klamath Falls, PacifiCorp Power Marketing, Inc. (now PPM Energy) and PacifiCorp for wind energy and net integration and exchange services, and for transmission with Bonneville and others for the period from 2005 through 2065, undiscounted, are:

Year Ending December 31	Estimated Payments
2005	\$ 279,466,548
2006	292,037,107
2007	278,744,203
2008	276,267,367
2009	263,836,954
2010 – 2014 ⁽¹⁾	824,988,890
2015 – 2019	515,466,992
2020 – 2024	395,186,504
2025 – 2029 ⁽²⁾	77,723,305
2030 – 2034	34,219,347
2035 – 2039	29,321,049
2040 – 2065	<u>22,938,642</u>
	<u>\$3,290,196,908</u>

(1) Bonneville Block and Slice contract expires September 30, 2011.

(2) Bonneville transmission contract expires July 31, 2025.

The effects of a proposed Northwest Regional Transmission Organization and other changes that could occur to transmission as a result of FERC’s proposed Standard Market Design are not known and are not reflected in the estimated future payments.

Payments under these long-term power contracts totaled \$234.6 million and \$251.8 million in 2004 and 2003, respectively. Payments under these transmission contracts totaled \$30.7 million and \$30.0 million in 2004 and 2003, respectively.

10. OTHER ASSETS

Other assets comprise deferred energy management costs and other deferred charges. Deferred energy management costs—net represent programmatic conservation costs. Seattle City Council-passed resolutions authorize the debt financing and deferral of programmatic conservation costs not funded by third parties and incurred by the Department. These costs are to be amortized to expense over 20 years.

Deferred power costs incurred for short-term wholesale power purchases during 2001 were recovered through rates at \$8.3 million per month through 2004, pursuant to SFAS No. 71 and Ordinance 120385.

Other deferred charges and assets—net consist of the following at December 31:

	2004	2003
Unrealized losses from fair valuations of:		
Short-term forward purchases of electric energy	\$ 269,411	\$ 163,664
Bonneville Slice contract true-up payment	2,070,957	1,898,666
Puget Sound Energy interconnection and substation	1,719,456	1,862,370
Studies, surveys, and investigations	1,680,622	533,435
Skagit Environmental Endowment	1,880,200	1,997,712
Endangered Species Act	1,511,438	1,341,435
Real estate and conservation loans receivable	414,608	473,169
Unamortized debt expense	6,169,024	5,315,921
General work in process to be billed	688,411	1,035,352
Other	275,650	1,349,997
	<u>\$ 16,679,777</u>	<u>\$ 15,971,721</u>

Unamortized charges for the deferral of contractual payments pursuant to the High Ross Agreement will be amortized between 2021 and 2035. The remaining components of other assets, excluding billable work in progress, are being amortized to expense over four to 36 years.

11. DEFERRED CREDITS

Deferred credits consist of the following at December 31:

	2004	2003
Bonneville conservation augmentation	\$ 26,795,501	\$ 24,200,537
Bonneville Slice true-up	-	6,348,625
Unrealized gains from fair valuation of		
short-term forward sales of electric energy	384,255	2,115,376
Levelized lease payments for Seattle office	483,639	919,404
Deferred capital fees	1,590,580	1,420,338
Customer deposits—sundry sales	2,749,414	1,107,614
Deferred grants	-	571,624
Deferred revenues—streetlight administration	673,822	-
Other	252,491	286,691
	<u>\$ 32,929,702</u>	<u>\$ 36,970,209</u>

12. PROVISION FOR INJURIES AND DAMAGES

The Department is self-insured for casualty losses to its property, including for terrorism, environmental cleanup, and certain losses arising from third-party damage claims. The Department establishes liabilities for claims based on estimates of the ultimate cost of claims. The length of time for which such costs must be estimated varies depending on the nature of the claim. Actual claims costs depend on such factors as inflation, changes in doctrines of legal liability, damage awards, and specific incremental claim adjustment expenses. Claims liabilities are recomputed periodically using actuarial and statistical techniques to produce current estimates, which reflect recent settlements, claim frequency, industry averages, City-wide cost allocations, and economic and social factors. Liabilities for lawsuits, claims,

and workers' compensation were discounted over a period of 15 to 17 years in 2004 and 2003 at the City's average annual rate of return on investments, which was 2.338% in 2004 and 3.161% in 2003. Liabilities for environmental cleanup and for casualty losses to the Department's property do not include claims that have been incurred but not reported and are not discounted due to uncertainty with respect to regulatory requirements and settlement dates, respectively.

The Lower Duwamish Waterway was designated a federal Superfund site by the Environmental Protection Agency ("EPA") in 2001 for contaminated sediments. The City of Seattle is one of four parties who signed an Administrative Order on Consent with the EPA and State Department of Ecology to conduct a remedial investigation/feasibility study to prepare a site remedy. The Department is considered a potentially responsible party for contamination in the Duwamish River due to land ownership or use of property located along the river. The estimated liabilities recorded related to this site totaled \$5.3 million and \$5.7 million for 2004 and 2003, respectively.

The schedule below presents the changes in the provision for injuries and damages:

	2004	2003
Unpaid claims at January 1	\$ 13,657,541	\$ 10,476,242
Payments	(2,262,497)	(2,391,275)
Incurred claims	<u>4,210,638</u>	<u>5,572,574</u>
Unpaid claims at December 31	<u>\$ 15,605,682</u>	<u>\$ 13,657,541</u>

The provision for injuries and damages is included in current and noncurrent liabilities as follows:

	2004	2003
Noncurrent liabilities	\$ 9,507,214	\$ 10,491,426
Accounts payable and other	<u>6,098,468</u>	<u>3,166,115</u>
	<u>\$ 15,605,682</u>	<u>\$ 13,657,541</u>

13. COMMITMENTS AND CONTINGENCIES

Operating Leases—In December 1994, the City entered into an agreement on behalf of the Department for a 10-year lease of office facilities in downtown Seattle commencing February 1, 1996. In early 1996, the City purchased the building in which these facilities are located, thus becoming the Department's lessor. In addition, the Department leases equipment and smaller facilities for office purposes through long-term operating lease agreements. Expense under the leases totaled \$3.9 million and \$3.8 million in 2004 and 2003, respectively.

Minimum payments under the operating leases are:

Year Ending December 31	Minimum Payments
2005	\$3,762,707
2006	502,194
2007	118,411
2008	90,751
2009	<u>4,409</u>
	<u>\$4,478,472</u>

Skagit and South Fork Tolt Licensing Mitigation—In 1995, FERC issued a license for operation of the Skagit hydroelectric facilities through April 30, 2025. On July 20, 1989, the FERC license for operation of the South Fork Tolt hydroelectric facilities through July 19, 2029 became effective. As a condition for both of these licenses, the Department has taken and will continue to take required mitigating measures. Total Skagit mitigation costs from the effective date until expiration of the Federal operating license were estimated at December 31, 2004 to be \$122.3 million, of which \$76.2 million had been expended; and for South Fork Tolt, \$4.1 million and \$1.1 million, respectively. Capital improvement, other deferred costs, and operations and maintenance costs are included in the estimates for both licenses.

Application Process for New Boundary License—The Department’s FERC license for the Boundary Project expires on September 30, 2011. The Department intends to submit an application for a new license by October 2009. A new license may require additional mitigation efforts for endangered species, including water quality standards, the full extent of which is not known at this time. Application process costs are estimated at \$43.3 million; as of December 31, 2004, \$3.9 million had been expended and deferred.

2005 Capital Program—The estimated financial requirement for the Department’s 2005 program for capital improvement, conservation, and deferred operations and maintenance including required expenditures on assets owned by others is \$165.5 million, and the Department has substantial contractual commitments relating thereto.

Project Impact Payments—Effective November 1999, the Department committed to pay a total of \$11.6 million and \$7.8 million over 10 years ending in 2008 to Pend Oreille County and Whatcom County, respectively, for impacts on county governments from the operations of the Department’s hydroelectric projects. The payments compensate the counties, and certain school districts and towns located in these counties, for loss of revenues and additional financial burdens associated with the projects. The Boundary Project located on the Pend Oreille River affects Pend Oreille County, and Skagit River hydroelectric projects affect Whatcom County. The combined impact compensation, including annual inflation factor of 3.1%, and retroactive payments totaled \$1.2 million and \$1.1 million to Pend Oreille County in 2004 and 2003, respectively, and \$0.8 million to Whatcom County in each year.

Endangered Species—Several fish species that inhabit waters where hydroelectric projects are owned by the Department or where the Department purchases power have been listed under the Endangered Species Act as threatened or endangered. On the Columbia River system, the National Oceanographic Atmospheric Administration Fisheries has developed a broad species recovery plan for listed salmon and steelhead, including recommendations for upstream and downstream fish passage requirements. These requirements include minimum flow targets for the entire Columbia Basin designed to maximize the

survival of migrating salmon and steelhead. As a result, the Department's power generation at its Boundary Project is reduced in the fall and winter when the region experiences its highest sustained energy demand. The Boundary Project's firm capability is also reduced.

Other Department-owned projects are not affected by the Columbia River. In Puget Sound, both bull trout and chinook salmon have been listed as threatened, and a draft recovery plan and proposed critical habitat for Puget Sound bull trout was issued by the U.S. Fish and Wildlife Service in July 2004. Bull trout are present in the waters of Skagit, Tolt, and Cedar River projects and chinook salmon occur downstream. While it is unknown how other listings will affect the Department's hydroelectric projects and operations, the Department is carrying out an ESA Early Action program in cooperation with agencies, tribes, local governments, and salmon groups that will assist in the recovery of bull trout and chinook salmon on the Skagit and Tolt. On the Cedar, the Department's activities are covered by a Habitat Conservation Plan that authorizes operations with regard to all listed species. Hydroelectric projects must also satisfy the requirements of the Clean Water Act in order to obtain a FERC license.

Streetlight Litigation—In November 2003, the Washington Supreme Court ruled that a 1999 ordinance related to inclusion of streetlight costs in the general rate base for Seattle and Tukwila customers was unlawful. As a result of this decision, the Department resumed billing the City of Seattle for streetlight costs. On May 21, 2004, trial court proceedings resulted in a ruling that the Department be required to refund the amount collected from ratepayers since December 1999 attributable to streetlight costs. The ruling also provided that the City of Seattle general fund will have to repay the Department for the streetlight costs that would have been billed over the same period.

On October 8, 2004, a partial judgment in the streetlight litigation was entered in Superior Court in King County. The judgment included a Remedy Stipulation that required the City's general fund to pay \$23.9 million to the Department, an amount which represents billings for streetlight services that should have been made to the City from December 1999 through November 2003. The \$23.9 million payment also included compensation to the Department for "loss of use" of funds, calculated as a percentage of the difference between the amount that should have been billed to the City and the amount paid by ratepayers for streetlight services. The City's general fund will pay the amount due on an installment schedule through April 2005. In 2004 the Department received payments totaling \$6.2 million from the City. An additional \$6.2 million was received in January 2005. The final payment of \$12.9 million is due on April 1, 2005.

The Department will refund to ratepayers in Seattle and Tukwila the amount of streetlight costs billed to them from January 2000 through November 2003. Gross refunds are estimated to be \$21.5 million, plus \$2.6 million to compensate ratepayers for loss of use of funds. Plaintiff attorney fees totaling \$3.3 million and \$0.7 million in administrative costs related to the refunds will be deducted from the gross refund amount, leaving \$20.0 million to be refunded to ratepayers. Refunds to current customers will be made through a credit on their electric utility bills. Currently inactive customers who received one or more billings during the period from January 2000 through November 2003 will receive refund checks on application to the Department.

The Department recorded the \$2.4 million difference between the \$23.9 million in payments from the City of Seattle and the \$21.5 million in customer refunds as other operating revenues in 2004.

The partial judgment entered on October 8, 2004 in the streetlight litigation also found that the City had inappropriately allocated to the Department certain central costs and ordered the City to refund \$1.0 million in such costs, including an allowance for loss of use, to the Department. Certain features of the City's One Percent for Art ordinance, as applied to the Department, were also found to be illegal. The City has filed an appeal relative to the One percent for Art finding.

Oregon Tax Claim—In 2001, the Oregon Department of Revenue assessed the Department, along with another northwest municipal utility, an *ad valorem* property tax for each utility’s respective interest in the Capacity Ownership Agreements with BPA for the Pacific Northwest Third AC Intertie transmission line. The assessment was for tax year 2001 with a retroactive “omitted property” assessment for years 1997 through 2000. The Oregon Court bifurcated the issues for trial into two phases: (a) liability for taxes, and (b) valuation method. In January 2004, the Court issued a ruling in favor of the cities for the “omitted property” claims, eliminating the assessments prior to 2001. In June 2004, as a result of changes to the Oregon Tax Code, a new “omitted assessment” was made for years 1999 and 2000. Trial is expected in 2005 for the new assessment matter.

The Department has retained legal counsel in Portland, Oregon to represent its interest in the Oregon courts. Any decision by the Oregon Tax Court in this matter is likely to be appealed to the Oregon Supreme Court. Because of the federal constitutional issues involved in this case, an appeal to the U.S. Supreme Court is also possible. Final resolution of the case in the near future is unlikely. Estimated exposure is approximately \$500,000 per year, for the years 2001 through 2004. Due to the uncertainty of the effect of this litigation on the Department’s financial position, the Department has not reserved an amount for a potential adverse judgment in these financial statements.

Other Contingencies—In the normal course of business, the Department has various other legal claims and contingent matters outstanding. The Department believes that any ultimate liability arising from these actions will not have a material adverse impact on the Department’s financial position or operations.

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